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Dear Nick,

NU-Link's Response to Ofgem's Further Consultation on the Cap Rate for the Cap and Floor Regime for Window 3 Electricity Interconnectors

As a developer of an interconnector project financed entirely through project finance, we appreciate the opportunity to provide feedback on Ofgem's consultation regarding the cap rate for the cap and floor regime under Window 3. Our project, like many others, relies exclusively on the cash flows generated from its operations to service debt and deliver returns to equity investors. This financial structure imposes stringent requirements for predictability and stability in revenue, making the parameters of the cap and floor regime critically important to the project's viability and the ability to deliver the modelled benefits to GB consumers.

This response highlights the unique challenges faced by project-financed interconnector developers and argues for a more tailored approach to setting the cap and floor parameters that reflects these challenges.

The Importance of Signalling an Adequate Expectation of Equity Returns

Project finance structures are characterized by a high degree of leverage, with debt typically covering a significant portion of the capital expenditure, often in the range of 70-80% of the projected capital expenditure. In NU-Link's case, the interconnector project's cash flows are the **sole** source of repayment for this debt and the **sole** means of providing returns to equity investors in the project. Consequently, any variability or uncertainty in revenue can have significant implications on the ability to finance the project and ultimately deliver benefits to GB consumers; especially where revenues fall short of projections in some years and which cannot be offset by higher revenues in other years.

The cap and floor regime is designed to mitigate some market risks by providing a safety net through the floor mechanism and limiting excessive profits through the cap. Lenders to

project-financed developments are primarily concerned with the adequacy and predictability of revenues at the floor level to ensure debt serviceability, whereas equity investors simply will not invest if the base case returns show revenues are persistently at the floor and hence not commensurate with the risk profile of the project.

For equity investors to pursue investing in NU-Link there needs to a cap well above the expected base case revenue levels to compensate those investors for the variability of revenues from year to year such that in aggregate there is more likely than not to be an adequate and reasonable rate of return over the life of the investment.

Where the proposed methodology leads to a structural lowering of the cap this will erode the potential for equity to accommodate risk when revenues are potentially at the floor for long periods.

Our response below considers the necessary revisions to setting the cap in this context since this is likely to lead to a different view to those projects which are being developed "on balance sheet" by developers with a diverse range of sources of income.

Concerns with the Proposed Methodology for Equity Beta

The consultation document outlines Ofgem's proposed methodology for calculating the equity beta for Window 3 interconnectors, which directly impacts the return on equity and thus the cap level. While the effort to align with broader regulatory practices is commendable, we urge Ofgem to consider the unique risk profile of project-financed interconnectors.

Equity beta is intended to capture the risk associated with the project compared to the broader market. However, project-financed assets, particularly those with a single asset, face unique risks not typically reflected in broad market indices. These include risks related to binary regulatory approvals, critical regulatory decision delays, construction risks and delays, commissioning issues as well as operational phase risks.

Any disruptions in any or all of these areas could severely impact the sole source of projected cash flows. The betas proposed may understate these risks, leading to a lower cap which will not adequately compensate the risk borne by equity investors. This is because the proposed comparator group is made of companies where the revenue from the interconnector is not the sole source of income for those firms.

The proposed comparator groups in the consultation document may be inappropriate for single-asset, project-financed businesses for several reasons. In Appendix 1 we provide detailed arguments explaining why these comparators may not accurately reflect the risk profile and financial realities faced by single asset interconnector businesses.

We recommend Ofgem considers an adjusted beta that reflects the specific risks of project-financed interconnectors, potentially by benchmarking against other infrastructure projects with similar risk profiles rather than against the broader market comparators proposed.

The Impact of a Conservative Cap Rate on Financing Costs

A conservative approach to setting the cap rate, while beneficial in providing more returns to consumers if revenues are above the cap, may inadvertently raise financing costs for developers by lowering expected revenues when at the cap. This will lead to higher required returns by equity investors to compensate for the increased risk of revenue insufficiency. This is particularly true in a rising interest rate environment, where the cost of debt (and therefore the floor) is increasing thus narrowing the potential band over which equity is able to earn a reasonable rate of return.

This will lead to equity investors demanding higher returns and will directly translate into a higher cost of capital; increasing costs for the project potentially making interconnectors at the margin less viable. This is counterproductive to the broader policy goal of encouraging interconnector development to enhance energy security of supply and integration across borders which ultimately protects the interests of GB consumers.

We urge Ofgem to carefully calibrate the cap rate to ensure it reflects a balance between consumer protection and the need to attract capital to finance these critical infrastructure projects. A more balanced approach could involve setting the cap rate which reflects the basis on which the interconnector will be financed, or incorporating mechanisms that adjust the cap in response to changes in market conditions, such as fluctuations in interest rates.

The Need for Flexibility in the Cap and Floor Mechanism

Interconnectors operate in a highly dynamic environment, influenced by factors such as regulatory changes, market conditions, and geopolitical events. The cap and floor regime must be flexible enough to accommodate these changes without undermining the financial stability of project-financed assets.

Unlike larger developers with diversified portfolios, single-asset developers bear all project-specific risks without the benefit of risk pooling. This lack of diversification heightens the importance of a stable and predictable regulatory environment

We recommend that Ofgem considers introducing periodic reviews or adjustment mechanisms within the cap and floor regime to account for significant changes in the operating environment. This could include adjustments to the cap levels based on actual project performance, changes in market conditions, or shifts in regulatory frameworks.

Such mechanisms would provide much-needed assurance to investors that the regulatory framework remains supportive of the project's financial health throughout its operational life and if abnormal returns become likely due to the materialisation of higher revenues beyond the expected range Ofgem would be able to ensure a consistent fair balance of risk and reward between investors and consumers.

The Role of the Cap and Floor Regime in Supporting the Energy Transition

The energy transition requires significant investment in infrastructure to facilitate the integration of renewable energy sources and enhance cross-border electricity flows. Interconnectors play a crucial role in this transition by linking markets and improving energy security.

The cap and floor regime is a critical enabler of interconnector investment. However, it must strike the right balance between protecting consumers and providing sufficient incentives for developers. An overly conservative approach to setting the cap rate could deter investment at a time when rapid expansion of interconnector capacity is needed to meet the challenges of the energy transition.

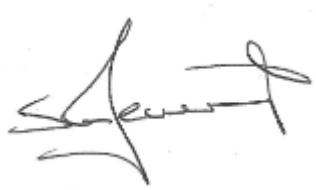
We urge Ofgem to consider the broader policy objectives of the energy transition when finalising the cap and floor parameters for Window 3. This includes ensuring that the regime remains attractive to all types of investors and capable of supporting the timely delivery of interconnector projects.

In conclusion, while we appreciate the need to align the cap and floor regime with broader regulatory practices, it is essential to recognize the unique challenges faced by project-financed interconnector developers. We strongly recommend that Ofgem consider the following when finalizing the parameters for Window 3:

1. Adjusting the equity beta to better reflect the specific risks associated with single-asset, project-financed interconnectors.
2. Ensuring that the cap rate is set at a level that balances consumer protection with the need to attract investment.
3. Introducing flexibility within the cap and floor regime to account for changes in the market and operating environment.
4. Providing specific provisions or adjustments for single-asset developers to ensure that the regime remains viable and supportive.
5. Considering the broader policy goals of the energy transition when setting the cap and floor levels to support the timely development of interconnector projects.

We appreciate the opportunity to contribute to the development of a robust and sustainable cap and floor regime and look forward to continued engagement with Ofgem on this critical issue. We remain committed to delivering a successful interconnector project that contributes to the UK's energy transition, delivers substantial GB consumer benefits and enhances cross-border electricity flows.

Yours sincerely



Steve Jennings

For and on behalf of NU-Link Interconnector.

Appendix 1

Category Comparison and Features		Comparator Groups	Single Asset Businesses
Difference in Risk Profiles	Diversification of Risk	The proposed comparator groups typically include companies with diversified asset portfolios, such as large utilities or energy companies. These firms have the ability to spread risk across multiple projects, geographies, and business segments. If one project underperforms, they can offset the impact with revenues from other assets.	In contrast, single-asset, project-financed businesses are fully exposed to the performance of a single project. Any adverse event such as delays, cost overruns, operational issues, or unfavourable market conditions directly impacts its entire revenue stream. This concentration of risk makes their risk profile significantly different from that of diversified firms.
	Operational and Revenue Risks	Large energy companies typically have established operational frameworks, mature technologies, and diversified income sources that reduce operational and revenue volatility.	These businesses are more vulnerable to operational risks, especially during the early stages of the project. Any disruption can lead to significant financial stress since they lack alternative income streams to cushion the impact.
Financial Structure and Leverage	Capital Structure	The proposed comparators often include companies with lower leverage, diversified financing options, and a mix of debt and equity across their operations. These companies can access capital markets with relative ease, reducing their cost of capital.	Project-financed projects typically involve high leverage, with debt often covering 70-90% of the capital expenditure. The high debt load increases financial risk, as cash flows from the project must be sufficient to meet debt service obligations. This leverage amplifies the impact of revenue fluctuations, making the financial health of the project more sensitive to changes in income and if the ability to make up for poor years becomes limited increases the overall equity risk and hence cost of capital.
Revenue Predictability and Stability	Regulated Returns vs Market Exposure	Large energy companies, especially those operating under regulated frameworks, often have more predictable and stable revenue streams. Regulatory frameworks can offer mechanisms that mitigate market risk, such as cost pass-throughs, rate adjustments, or capacity payments.	Interconnector projects typically operate in more volatile market environments, with revenues subject to fluctuations in electricity prices, demand, and cross-border trading conditions. This revenue volatility makes single-asset projects riskier compared to firms with regulated, stable income.
Cost of Capital Considerations	Equity Beta Calibration	The proposed comparators may have a lower equity beta due to their diversification, regulated environments, and lower operational risks. This lower beta reflects a lower risk premium for their investors.	The equity beta for a single-asset, project-financed business should be higher to reflect the higher risks associated with concentrated revenue streams, high leverage, and market exposure. Using a beta calibrated to diversified companies would understate the true cost of equity for single-asset developers, potentially leading to an inadequate cap rate that does not compensate investors for the risks they are bearing
	Investor Expectations	Investors in large, diversified companies may accept lower returns due to the lower perceived risk and more stable cash flows.	Investors in project-financed projects expect higher returns due to the concentrated risk profile and the high stakes involved in the success of a single project. An inappropriate comparator group would lead to a mismatch in expected returns, making it difficult for single-asset projects to attract necessary investment.

Regulatory and Market Context Differences	Geographic and Regulatory Variance	The proposed comparators might include companies operating in different geographic and regulatory environments, where risks and market conditions differ significantly from those faced by a single-asset interconnector project. These differences can include variations in regulatory stability, market liberalization, and support mechanisms for infrastructure projects.	A single-asset interconnector project is often bound to a specific regulatory environment and market, with its revenue largely dependent on the local context. Using a comparator group that operates under different conditions could lead to mispricing of risk and an inappropriate setting of the cap and floor levels.